

MEMORANDUM OF LAW

DATE: June 9, 1986

TO: Joe Lozano, Assistant City Auditor &
Comptroller

FROM: City Attorney

SUBJECT: Medicare Withholding Tax

In a recent memorandum you asked this office numerous questions concerning the mandatory Medicare tax for employees hired by The City of San Diego on or after April 1, 1986 pursuant to the provisions of section 13205 of the Budget and Reconciliation Act [Public Law 99-272, 100 Stats. 313 (1986)] (the "Act"). You indicated that you needed assistance in determining how the new Medicare tax was to be implemented. We will answer your questions, concerning the tax withholding requirements of the Act, seriatim. We remind you, however, that the Internal Revenue Service has not yet published regulations concerning its interpretation of section 13205 of the Act. Once they are published, if you have any questions concerning them, feel free to contact this office.

QUESTION NO. 1

WHICH EMPLOYEES ARE SUBJECT TO THE MEDICARE TAX?

With certain limited exclusions, all state and local government employees hired on or after April 1, 1986 are subject to the Medicare tax provisions of the Act. Section 13205(a) of the Act amends subsection (u) of section 3121 of the Internal Revenue Code and makes the taxes imposed by sections 3101(b) and 3111(b) applicable to employees in the service of any state or political subdivision of a state. Service is not treated as employment if the service is included under a voluntary agreement for coverage pursuant to section 218 of the Social Security Act, or if the service is performed by an individual who is employed by a state or a political subdivision of a state to relieve him or her from unemployment. Employment in a hospital, home or other institution by a patient or inmate as an employee of a state or political subdivision or of the District of Columbia is

excluded from coverage. Temporary employment with a state, a political subdivision of the state or the District of Columbia in case of fire, storm, snow, earthquake, flood or other similar emergency is excluded. In addition, individuals serving as employees under section 5351(2) of Title 5 USC (relating to certain interns, student nurses and other student employees of

hospitals of the District of Columbia government) other than as a medical or dental intern or a medical or dental resident in training are also excluded from the provisions of the Act. These are the only exclusions. It is clear from the express language of the Act that new police, fire and hourly employees are now subject to the Medicare tax even though they were not previously required to participate in the Social Security System.

QUESTION NO. 2

WHAT IS THE DEFINITION OF A NEW HIRE, AS IT APPLIES TO THIS TAX? ARE EMPLOYEES, WHO RETURN TO CITY SERVICE AFTER LEAVES WITHOUT PAY, CONSIDERED NEW HIRES?

New subsection 3121(u) of the Internal Revenue Code provides an exception for current employees. Current employment is defined as service performed by an individual who was performing substantial and regular service for remuneration for that employer before April 1, 1986 and who was a bonafide employee of that employer on March 31, 1986. The employment relation with that employer must not have been entered into for purposes of claiming the exemption and the employment relationship with the employer must not have been terminated after March 31, 1986. We believe an employee on approved leave of absence with or without pay from the Civil Service Commission or on extended military leave is currently employed by The City of San Diego within the above definition. However, if an employee severed his or her employment relationship with The City of San Diego and then returns to The City of San Diego as a new hire or reinstatement, he or she will be subject to the Medicare tax.

QUESTION NO. 3

ARE THE FOLLOWING TYPES OF PAYMENT SUBJECT TO THE MEDICARE TAX?

A. PERSONAL SICK LEAVE TAKEN.

Section 3121(a) of the Internal Revenue Code provides that the term "wages" means all remuneration from employment including the cash value of all remuneration (including benefits) paid in

any medium other than cash except as specifically excluded by section 3121. Section 3121(a)(2)(A) excludes any amount of payment by an employer made to or on behalf of an employee on account of sickness or accidental disability or for sickness or accidental disability insurance but in the case of payments made to any employee or any of his dependents, it only excludes from the term "wages" payments which are received under a worker's compensation law or medical or hospitalization expenses in connection with sickness or accidental disability. Section

3121(a)(4) provides that sick leave paid after the employee has been absent for six calendar months following the last calendar month in which the employee worked for such employer is also excluded from the definition of wages.

B. LONG TERM DISABILITY (LTD) PAYMENTS.

The above analysis is also applicable to Long-Term Disability Plan payments.

C. WORKER'S COMPENSATION PAYMENTS.

Worker's compensation payments by The City of San Diego on behalf of the employee are clearly not subject to the Medicare tax provisions pursuant to section 3121(a)(2)(A).

D. INDUSTRIAL LEAVE PAYMENTS.

Industrial leave payments which the City has a legal obligation to provide are in the nature of worker's compensation payments and are not subject to the Medicare tax.

E. EXCEPTIONAL PERFORMANCE PAY.

There is no exclusion under the Act for exceptional performance payments, therefore, they are wages under section 3121(a) and subject to the Medicare withholding tax.

**F. FLEXIBLE BENEFIT PLAN AND MANAGEMENT
BENEFIT PLAN TAXABLE OPTIONS - CASH,
IDS PLANNING SERVICE OR OTHER TAXABLE BENEFITS.**

These taxable benefits are subject to the Medicare tax.

G. AUTOMOBILE AND PARKING ALLOWANCES.

These fringe benefits are also subject to the Medicare tax pursuant to section 3121(a).

H. SUGGESTION AWARD PAYMENTS.

These payments are also subject to the Medicare tax pursuant to section 3121(a).

I. UNIFORM AND TOOL ALLOWANCES.

Uniform and tool allowances are also subject to the Medicare tax pursuant to section 3121(a).

**J. UNUSED SICK LEAVE AND ANNUAL LEAVE
EITHER PAID OFF UPON TERMINATION,
RETIREMENT, IN A LUMP SUM OR PAID
OFF UPON RETIREMENT DEFERRED.**

All of these benefits are subject to the Medicare tax pursuant to section 3121(a).

K. ANNUAL LEAVE TAKEN IN TERMINAL LEAVE STATUS.

This benefit is subject to the Medicare tax provisions pursuant to section 3121(a).

L. SUPPLEMENTAL PENSION SAVINGS PLAN (SPSP) DISTRIBUTION

(1) Employee interest.

Employee interest and employer interest are not subject

to Medicare withholding because interest payments are not included in the definition of wages in section 3121(a).

(2) Employer contributions.

Employer contributions made to or on behalf of an employee to a trust described in section 401(a) which are exempt from tax under section 501(a) at the time of such payment are exempt except under narrow conditions which are not applicable to The City of San Diego. We believe that SPSP is qualified under section 401(a) and therefore the City's contributions are exempt from the Medicare tax.

M. INTEREST ON RETIREMENT CONTRIBUTIONS.

The Medicare tax is not applicable to interest earned on retirement contributions.

N. OTHER NON-CASH COMPENSATION (SUCH AS RECOGNITION AWARD GIFT CERTIFICATES).

To the extent that any award gift certificate has a cash value, the cash value is subject to the Medicare tax pursuant to the provisions of section 3121(a) of the Act.

QUESTION NO. 4

IS THE TAX CALCULATED ON WAGES BEFORE OR AFTER NON-INCOME TAX DEDUCTIONS, SUCH AS DEFERRED COMPENSATION AND 401(k) SAVINGS PLAN DEDUCTIONS?

Payments to an exempt governmental deferred compensation plan are exempt from Medicare tax under paragraph 3121(a)(2)(e). There is, however, a significant problem with contributions by the City to an employee's 401(k) plan. Section 3121(v) of the Internal Revenue Code provides that employer contributions to a 401(k) plan which permits an employee to elect that the contribution be paid in cash to the employee are not exempt from the Medicare tax. Therefore, when an employee hired after April 1, 1986 becomes eligible to allocate part of his or her Flexible Benefits Plan or Management Compensation benefit to the 401(k) plan, that amount will be subject to the Medicare tax.

QUESTION NO. 5

DOES THE MEDICARE TAX HAVE ANY AFFECT ON EITHER THE CITY EMPLOYEES' RETIREMENT SYSTEM OR THE 1981 PENSION PLANS, INCLUDING CONTRIBUTION RATES?

According to section 3121(a)(5), any payments made to or on behalf of an employee from or to a trust which is exempt from the tax under section 501(a) at the time of such payment is not subject to the Medicare tax. Therefore, contributions by the City to the City employee's retirement system are not subject to the Medicare tax.

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By

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